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SUBJECT: SOCIALISTS CONTINUE MACROECONOMIC PROGRESS, BUT
REFORMS ARE SLOW AND INCOMES REMAIN LOW

REF: A) Sofia 810; B) Sofia 741; C) 05 Sofia 1925

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¶1. (SBU) SUMMARY: Almost one year into its tenure, the Socialist-led government has succeeded in preserving macroeconomic stability, growing the economy and preparing the country to meet EU convergence criteria. The coalition government has maintained the key elements of the previous government's economic policy, hinged on adhering to the Currency Board Arrangement and a conservative fiscal policy. While the Bulgarian economy continued to grow strongly in the first quarter of 2006 (5.6 percent), the balance of payments position is the single macroeconomic indicator which has been deteriorating (7.3 percent in Jan.-May 2006.) The government has significantly curtailed its election promises in the area of social spending, while PM Stanishev introduced measures aimed at sustaining economic growth -- cutting social security insurance payments by six percent -- and providing real tax relief for low income citizens and moderate increases in public wages and pensions. End Summary.

GROWTH CONTINUES . . .

¶2. (U) Resisting calls for populist measures, the Socialist-led coalition government has held to an IMF-backed tight fiscal policy. It has also introduced cuts in the social security insurance payments (from 42 percent to 36 percent) that have injected 600 million leva (USD 387 million) into the economy, and brought in more green-field investments. This approach has led to strong results applauded by the EU and the international financial institutions:

-- GDP increased by 5.6 percent in the first quarter of ¶2006. While the GOB recently revised downward the estimated GDP growth for 2006 from 5.5 percent to 5.3 percent, other independent observers estimate a lower growth of 4.6 percent due to the central bank's restrictions on bank lending, higher inflation and slower wage growth;

-- The government is committed to a further fiscal tightening in 2006 to reach a surplus of 3 percent (about 1.4 billion leva or USD 903 million). The Finance Ministry has reported that the general budget surplus stood at 1.3 billion leva (USD 839 million) in May. The macroeconomic framework for 2007-2009 envisages a budget surplus of 0.8 percent of GDP for 2007;

-- Despite the initial price push earlier this year, the

inflation outlook remains benign at an estimated rate of 5 percent for 2006. Inflation stood at 2.9 percent for the period January-June 2006.

-- The unemployment level fell to a record low level of 9.2 percent (340,059 registered unemployed) in June;

-- Declining government debt of 6.4 billion euro or 27.5 percent of GDP in May 2006 (far below the euro-zone requirement of 60 percent of GDP);

-- Comfortable foreign exchange reserves of 7.9 billion euros.

. . . BUT CURRENT ACCOUNT DEFICIT WIDENS

¶3. (U) Bulgaria's current account deficit has been widening on the back of strong economic growth, driven by high import demand for industrial inputs, oil and consumer goods. The most recent balance of payment data show that the current account deficit rose sharply to 1.7 billion euro or 7.3 percent of GDP in the first five months of 2006 compared to one billion euro or 4.7 percent of GDP for the same period last year. The current account deficit is expected to widen to 12.4 percent by the end of the year.

¶4. (U) However, financial inflows in the form of foreign direct investment (FDI), tourist revenues and remittances remained steady, helping the deteriorating current account deficit. For instance, new FDI in the period of January-May 2006 increased by 67 percent--to 1.2 billion euro--compared to the same period last year covering 68 percent of the existing current account deficit. The InvestBulgaria Agency (IBA) estimates FDI of 2.3 billion euro for 2006 thanks to the expansion of existing foreign investment, green-field investment projects to be completed by the end of the year

and reestablished momentum in the privatization process.

REINVIGORATING THE PRIVATIZATION PROCESS

¶5. (SBU) The privatization process considerably slowed down in 2005. The Privatization Agency (PA) reported that a total of 31 minor deals involving the sale of majority ownership were concluded in 2005 compared with previous projections of 46 privatization deals for 2005. The failure to complete a single major privatization transaction in 2005, however, underscores the government's difficulty - at times - in attracting respected foreign investors through privatization and finalizing already negotiated deals.

¶6. (U) The GOB is working on reinvigorating the privatization process and completing the sell-off of large state-owned enterprises (SOEs) in 2006. The privatization program of the government envisages the sale of majority stakes of 24 state-owned enterprises, 164 residual stakes in previously privatized companies and 10 detached units from existing SOEs for the equivalent of 600 million leva in 2006 (USD 387 million.) While the PA will continue the sale of residual minority stakes through public offering on the stock exchange, the main goal of the 2006 privatization program is the quick sale of the remaining majority state-owned stakes, including:
--the national carrier Bulgaria Air;
--the sea transportation company Bulgarian Maritime Company;
--five district heating companies;
--thermo-power plants in Varna and Bobov Dol; and
--plants and trading companies in the military industry.

MARGINAL INCOME GAINS

¶7. (SBU) The BSP could not realistically deliver on many of

the party's generous election promises, but the GOB's economic policy has still placed a special emphasis on social policy with a focus on reforms of the personal income tax and public sector salary and pension increases (Ref. C). The thrust of the government's social program is to change the structure of the personal income tax brackets and raise the amount of non-taxable income. The GOB is currently contemplating its income policy for 2007-09 highlighted by a minimum monthly salary between 170-219 leva (USD 110-141) and roughly a 10 percent increase in salaries and pensions.

¶8. (U) Specific social policy measures include:

--simplifying the personal income tax regime through cutting the four income tax brackets to three and raising the non-taxable monthly income threshold by almost 40 percent, from 130 leva (USD 84) to 180 leva (USD 116);
--an increase in the monthly minimum wage by seven percent to 160 leva (USD 130);
--an increase in the public sector salaries by six percent effective July 1, 2006 resulting in an average public monthly wage of 460 leva (USD 297);
--an increase of five percent in pensions effective January 1, 2006; and
--the Council of Ministers decided April 2006 to extend an additional 500 million leva (USD 323 million) for the implementation of its poverty reduction program geared towards education and vocational training. Initially, the GOB budgeted 2 billion leva (USD 1.3 billion) for this program.

IMF AGREEMENT

¶9. (U) Bulgaria's relations with the International Monetary Fund (IMF) are good, and are often described as a success story (Ref. B). The Socialist-led government has reinforced its eagerness to institute the right economic policies and commitment to undertake necessary structural reforms by agreeing to extend until March 2007 the two-year, USD 146 million stand-by arrangement due to expire in September.

¶10. (SBU) COMMENT: The overall macroeconomic policy of the Stanishev-led government has been strong. While keeping the budget well under control and continuing the pattern of growth, the current government seems also to be committed to raising incomes and the standard of living through tax cuts for low incomes and mandatory increases in public salaries

and pensions. However, with an average monthly salary of 329 leva (USD 212), incomes continue to be inadequate to cover the cost of living. Much will depend on the GOB's progress in stepping up structural reforms, including creating a better business environment (Ref. A), which will allow private businesses to create more well-paid jobs.

LEVINE